STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	:	
	:	
Proposed general increase in water rates. (Tariffs filed on May 28, 2004.)	:	**ICC Docket No. 04-0442**
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REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Reply Brief in the above-captioned matter.

I. INTRODUCTION

In this proceeding, the Commission is investigating Aqua Illinois, Inc.'s ("Aqua" or the "Company") May 28, 2004 request for a general increase in water rates for its Vermilion Division ("Vermilion") pursuant to Article IX of the Illinois Public Utilities Act ("Act"), (220 ILCS 5/9). Initial briefs were filed on December 10, 2004, by Aqua Illinois, Inc. ("Aqua IB") and the Staff of the Illinois Commerce Commission ("Staff IB" or "Staff's Initial Brief"). Staff's Initial Brief identified and responded to many if not most of the arguments raised in the Company's Initial Brief. In this Reply Brief Staff has incorporated many of those responses by reference or citation to Staff's Initial Brief. However, in the interest of brevity, Staff has not raised and repeated every argument and response previously addressed in Staff's Initial Brief. Thus, the omission of a response to an argument that Staff previously addressed simply means that Staff stands on the position taken in Staff's Initial Brief because further or additional comment is neither needed nor warranted. As explained in detail below and in Staff's Initial Brief, the arguments raised by Aqua lack merit and must be rejected.

II. ARGUMENT

A. Operating Revenues, Expenses And Income

1. Payroll Expense

Aqua points out in some detail in both the Introduction and Payroll Expense portions of its Initial Brief that its budget for the future 2005 test year has been closely examined by the independent accounting firm London Witte Group, Inc. (Aqua IB, pp. 1, 3.) While Staff certainly lauds this, Staff reminds Aqua that 83 Ill. Adm. Code 285.7010(a) **requires** Aqua to provide "a statement from an independent certified public accountant that the preparation and presentation of the applicable schedules comply with the Guide for Prospective Financial Information". Furthermore, simply because Aqua's budget is in full conformity with the American Institute of Certified Public Accountants' guidelines, it does not automatically follow that the costs associated with that budget are recoverable for ratemaking purposes.

Staff's position is that payroll costs should be decreased based on the Company's historic over budgeting total payroll costs. (Staff IB, p. 9.) Since the Company has not explained how its budgeting process has changed from the historic period reviewed by Staff (Tr., p. 245), it is only reasonable to expect that the sustained pattern of over budgeting will continue into the 2005 payroll projections. Aqua indicates that it has not projected conditions causing budget variances in 2005 or future years. (Aqua IB, p. 6.) Staff, and indeed any person who develops a budget, would be very surprised to see a budget that is based on conditions not anticipated to occur. The statement that "Staff obviously could not identify any unanticipated capital projects that are anticipated to occur in 2005" (Aqua IB, p. 5) is oxymoronic at best. History shows that the Company has consistently over budgeted its payroll costs. The Company's test year payroll costs are based upon its 2005 budget and there has been no change in the Company's budgeting process. The fact that the Company can now, in hindsight, identify the various unanticipated conditions that caused its budget variances in prior years does not, in and of itself, establish that the Company has improved its ability to forecast. Staff has adjusted the payroll budget consistent with the Company's demonstrated track record for accuracy in its forecasts.

The Company claims that Staff did not consider expenses expected to be incurred in 2005. (Aqua IB, p. 4.) The Company is incorrect. The record is clear that Staff did consider capitalized payroll variances and has accounted for them in the analysis presented in ICC Staff Exhibit 6.0, Schedule 6.2, page 2. Staff's position and analysis summary is more fully presented in its Initial Brief on pages 10 – 12. Staff also considered the Contractual Services Budget Variances and found that the Company has increased its budget for that expense item. While the Company claims that its budgets for 2004 and 2005 are inadequate, it failed to provide any support for the actual 2004 costs requested by Staff in data request TEE 5.09. The Company's claims regarding current costs and the inadequacy of its own budgeting remain unsupported and should be given little, if any, weight in the final determination of this issue. (Staff IB, p. 12.)

Aqua claims Staff's adjustment would produce substantial budget variances. (Aqua IB, p. 6.) The Company provides unsupported calculations in its attempt to demonstrate the impact of Staff's adjustment to the historic period 2001 to 2003. (*Id*., p. 8.) Staff's "intent" is not to "correct budget variances" from the past as the Company claims, but rather to derive a "normal" future level of payroll expense on which to base rates in this docket.

The Company claims that Staff's adjustment would impact jobs. (*Id*.) Nothing exists in the record in this case to support the Company's claim. The comparison between Staff's proposal for payroll expense and the amount approved for payroll expense in the 2000 rate case should also be disregarded since Staff's adjustment is actually an increase over payroll incurred during 2001, the test year in the 2000 rate case. Staff's argument on this issue is more fully discussed in its Initial Brief on pages 10 – 11. The Company's argument regarding Aqua's service quality being hampered (Aqua IB, p. 9) should likewise be disregarded. Staff is in fact recommending an increase in payroll costs, not a decrease as the Company claims. (Staff IB, pp. 10 – 11.)

Lastly, the Company requests that if the Commission accepts Staff's payroll adjustment, it should make a consistent adjustment to Contractual Services. (Aqua IB, p. 9.) Staff disagrees that contractual services and labor expense items are sufficiently similar to require or merit the same treatment. Since these two expense items are not as directly related as the Company insinuates and each reflects a different fact pattern, the same theory of evaluation cannot be applied to both items to produce the same result for each item as the Company contends. Staff more fully discusses this issue in its Initial Brief on pages 12-13. The Company failed to provide Staff with support for the 2004 year to date Contractual Services Cost (Staff IB, p. 12), thus it is the Company's position, rather than Staff's position, that is unsupported.

Staff recommends that the Commission approve its adjustment to decrease Payroll Expense by $90,129.

2. Payroll Taxes

Staff agrees with the Company that the final resolution of the FICA, SUTA and FUTA Payroll Taxes as well as the Capitalized Payroll Tax amounts are dependent upon the Commission's final determination of total Payroll Costs, both expensed and capitalized approved in its final Order. (Staff IB, pp. 4 and 7; Aqua IB, p. 12.)

3. Incentive Compensation Expense

Staff recommends that the Commission disallow the costs associated with Aqua's incentive compensation plan (the "plan") because:

1) The plan is dependent upon financial goals of the Company which benefit shareholders and not ratepayers;

2) The goals in the plan may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding;

3) The plan is discretionary and may be discontinued at any time;

4) There is not sufficient comparable historical data on which to determine if the test year level is reflective of a "normal" level; and

5) The disallowance of incentive compensation is consistent with prior Commission Orders.

(ICC Staff Exhibit 2.0, p. 10, lines 175-185.)

The Company claims, that since in Docket No. 03-0403 the Commission allowed recovery of incentive compensation expense, recovery should also be approved in this docket. (Aqua IB, p. 13.) Staff disagrees.

Aqua claims that Staff's adjustment is contrary to the Order in Docket No. 03-0403. (*Id.*) In fact, the Company's treatment of incentive compensation costs is contrary to the Order in Docket No. 03-0403, as more fully explained in Staff's Initial Brief on pages 21 – 23.

The Company also claims the Commission has allowed recovery of expenses associated with its incentive compensation plan since 1997. (Aqua IB, p. 13.) The Company, however, has indicated that the plan has undergone significant changes from 2000 – 2003. (*See* Staff IB, p. 19.) In Docket No. 99-0288, Staff witness Ebrey recommended that, based on support of goals and outcomes experienced by the Company, a portion of the Incentive Compensation Expense requested by the Company be approved by the Commission. (Docket No. 99-0288, ICC Staff Exhibit 1.00, p. 20.) Had similar support been provided in the instant proceeding, the Staff witness Ebrey would have conducted a similar analysis. However, due to changes in the plan and the lack of support of goals and objectives, Staff was precluded from making such an analysis here.

The Company claims Staff's adjustment is contrary to the evidence that ratepayers benefit from Aqua's incentive Compensation plan. (Aqua IB, p. 14.)

However, under cross-examination, Company witness Schreyer was unable to indicate the detailed objectives, quantifiable results of the objectives, specific dollar savings or the benefits to ratepayers he purported his Schedule S-2.2 to present. (Tr., pp. 119 – 120.)

The Company offers its same unpersuasive responses to Staff's five main points for disallowance of Incentive Compensation Expense. (Aqua IB, pp. 16 – 17.) Staff refuted each of those responses in its Initial Brief (Staff IB, pp. 14 – 21), however, some of the Company's statements merit further response here.

The Company states that "Further, the Commission already found in Docket No. 03-0403 that compensation under Aqua's plan is not tied directly to earnings." (Aqua IB, p. 16.) Nowhere in the Order in Docket No. 03-0403 is such a statement made. The Company has failed even once in this case to discuss the plan's dependency on financial goals of the Company that only benefit shareholders, even though the plan itself clearly indicates that is the case. (Staff IB, p. 15.)

The Company claims that since payments have been made under the plan since 1995, the full amount budgeted should be recovered from ratepayers. (Aqua IB, p. 16.) However, as Staff points out, in the most recent two years of data provided, the Company paid out 75% or less of the budgeted amount for incentive compensation. If the amounts of budgeted incentive compensation expense had been included in rates for those years, the 25% of budgeted incentive compensation expense not actually incurred would have gone directly to the shareholders, with no benefit to ratepayers who would have provided those funds. (Staff IB, pp. 16-17.)

The Company quotes Mr. Schreyer's testimony that it has exercised its discretion to continue the plan. (Aqua IB, p. 17.) Staff also indicates how the Company has exercised its discretion to discontinue the plan for union employees as of June 1, 2002. (Staff IB, p. 17.) By its very definition, a discretionary plan may be discontinued at any time. Just because the Parent Company claims the plan will continue in 2005, that has no bearing on whether it will actually continue beyond 2005. That decision, as described in the plan, is made on a year-to-year basis. (*Id*., p. 18.)

The Company calculates an annual average incentive compensation of $36,826 as sufficient payment history to support a normal level of expense. (Aqua IB, p. 17.) Staff counters that the number of employees who actually received payment under the incentive compensation plan has changed from the inclusion of all union employees in 2002, to just six non-union employees in 2003 and only three non-union employees in 2004. (Tr., pp. 274 – 275.) A simple average based on plan years with ever decreasing payouts does not provide a representative base for determining a "normal" level of expense.

While the Company claims that the Orders Staff cites as support for its position address entirely different compensation plans (Aqua IB, p. 17), the analysis and basis for the adjustments in those dockets are the same as those Staff used in the current docket. In fact, this is precisely what the Commission did in its Order in Docket No. 03-0403, when it told the Company that it must demonstrate ratepayer benefits in order to recover incentive compensation costs in future cases. (Staff IB, p. 21.)

Staff recommends that the Commission approve its adjustments disallowing incentive compensation expense reducing Operating Expenses by a total of $33,790.

4. Collections Expense

The Company is correct that Staff is proposing to remove the same amount from Management Fees that it also removed (and the Company accepted) from Collections Expense. (Aqua IB, p. 18.) However, the Company's claim that the increased budget for Management Fees does not include an allowance for Remittance Center Costs is unsupported. During cross-examination, Staff witness Ebrey explained that the Company did not offer any support for the increase in Management Fees in response to her data request TEE 7.05. (Tr., pp. 233 – 234.) Since the burden of proof in a rate case lies with the Company (220 ILCS 5/9-201(c)), and the Company failed to support its claim that the costs associated with the Remittance Center are not included in the increase in Management Fees for the test year, Staff's adjustment is reasonable and should be approved. (Staff IB, p. 32.) Since Management Fees expense is the appropriate account in which to record this type of cost, the budget for the cost increased by over $200,000 from 2003 and 2005, and the Company failed to explain that increase, it is reasonable to conclude that the costs at issue are included in the increased Management Fees. (*Id*., p. 31.)

Staff recommends that the Commission approve its adjustment reducing Management Fees by $19,246.

5. Advertising Expense

Staff's adjustment to advertising expense removes costs that are promotional or goodwill in nature or that remains unsupported by the Company. (Staff IB, p. 24.)

The Company mistakenly attributes a number of statements to Staff. At no point in Staff's testimony does Staff claim that the "good-will advertising is not informative to consumers". (Aqua IB, p. 18.) Further, Staff never offered the opinion "that consumers do not benefit from receiving information". (*Id.,* p. 19.) In fact, the quote cited by the Company in its Initial Brief clearly shows that Staff does not have an opinion regarding customer benefits from receiving information such as the Company described. (*Id*.) Furthermore, Company witness Schreyer admitted under cross-examination that the statement attributed to Staff was only his own characterization of Staff's testimony and he could not cite to anything in the record. (Staff IB, p. 24.)

The Company claims that since it is the only water service provider in the Vermilion area, it has no need for promotional advertising. (Aqua IB, p. 19.) Staff agrees and believes this is one of the reasons the Company should not recover the costs of such advertising from its ratepayers. Staff's analysis of the radio transcripts clearly shows that only half of the ads provide information, as detailed in Section 9-225 of the Act and as discussed in ICC Staff Exhibit 2.0, pp. 18-19, lines 355-364, for which costs should be included in the revenue requirement (Staff IB, pp. 25 – 26), with the other half being promotional advertisements.

The Company states that it "believes consumers want to be informed of whether their water utility has satisfied the IEPA's Safe Drinking Water standards". The Company further states that the IEPA requires utilities to release the results of water testing in an annual Consumers Confidence Report. (Aqua IB, p. 20.) Nowhere are there requirements that a radio advertisement is required in addition to the IEPA Consumers Confidence Report. These additional advertisements are only promoting the Company to its already captive ratepayers. While a category of advertisements may be beneficial or informative, neither of those reasons assures recovery through rates when a Company chooses to make those advertisements predominately promotional in nature.

The Company claims that "'explanations of existing..rate schedules' is a category of advertising that 'shall be considered allowable'". (Aqua IB, p. 21.) However, upon review, the advertisement to which the Company refers does not explain rate schedules, but simply promotes the Company stating, "It's nice to know there are still some great bargains available". (ICC Staff Exhibit 6.0 Attachment C, page 1 of 2.) How can this be looked upon as anything but promoting the Company to its captive ratepayers, who cannot be on the lookout for "great bargains"?

While the Company does not address them specifically, an additional $905 in various promotional costs, not a part of the radio advertisements, are also disallowed in Staff's adjustment.

The Company mistakenly indicates that Staff is disputing only the $3,000 increase in newspaper advertising. (Aqua IB, p. 22.) Staff has also removed an additional $1,343 in promotional costs in Staff's total adjustment to advertising expense of $(9,540). The Company does not address those costs anywhere in the record. The Company does focus on the $3,000 increase in newspaper advertising costs, claiming that an undefined "sufficient level of market saturation" must occur at the direction of its own Community Advisory Panel. (*Id.*) While the Company's Community Advisory Panel may recommend the Company increase customer notifications, that in itself does not support an increase in recoverable costs. (Staff IB, pp. 26 – 27.)

The Company has failed once again, as it did in Docket Nos. 00-0339 and 03-0403, to sufficiently demonstrate the recoverability of its proposed advertising expenses. Staff recommends that the Commission accept its adjustment to reduce Advertising Expense by $9,540.

6. Charitable Contributions Expense

The Company claims that, since Staff did not talk with the organizations to which Aqua made donations, Staff's objection to the recoverability of those donations is unsupported. (Aqua IB, p. 23.) How the organizations actually used the specific donations is not the determining factor for recoverability. Rather, the substance of those donations must be considered. Staff proposes to disallow certain costs because they are:

1. Payments for Economic Council dues;
2. Payments that are promotional, goodwill or institutional in nature;
3. Payments made to non-charitable organizations. (Staff IB, p. 28.)

Staff has addressed each of its bases for disallowance of costs categorized as contributions by the Company as well as the Company's responses in its Initial Brief. (Staff IB, pp. 28 – 30.) Of particular note is that the actual third-party documentation reviewed by Staff clearly support Staff's adjustments to disallow "membership dues" (*Id.*, p. 28) and "sponsorships" (*Id.*, p. 29).

Staff's third area of disallowance, educational subsidies, is only for the benefit of those specific individuals to whom the amounts were awarded. (*Id.*, p. 30.) The Company claims that the "whole community benefits from the development of youth" and that the purpose of College Scholarships is "protecting the environment" (Aqua IB, p. 27), yet provides no explanation of how these unsupported and unexplained claims demonstrate the recoverability of this type of cost as a Charitable Contribution.

Staff recommends that the Commission approve its adjustment to reduce Charitable Contributions Expense by $27,675.

7. Rate Case Expense

Aqua's main argument with respect to rate case expense appears to be its contention that Staff is to blame for its increased fee estimate. (Aqua IB, p. 28.) Aqua's assertion is baseless, and completely fails to address Aqua's improper attempt to revise its rate case estimate late in this proceeding. As explained in Staff's Initial Brief, not only is Aqua's request contrary to the Commission's general practice of limiting recovery of rate case expense to the utility's filed estimate, but it is also contrary to the Commission's practice of declining to consider any revision made in a time and manner that prejudices Staff's or other parties' ability to prepare its case. (*See* Staff IB, pp. 40-41, 43-45.)

Aqua attempts to blame Staff by protesting that it was forced to relitigate incentive compensation and NAIC-2 designation risk premium issues addressed in prior

Commission Orders. (*See* Aqua IB, p. 28.)[1] This argument is without merit. The rate case expense issue to be decided is whether Aqua properly proposed and supported an addition to its original estimate of rate case expense, not to explore the myriad causes of any increase.

The fact of the matter is that Aqua has failed to support its increased estimate. (*See* Staff's Initial Brief, pp. 39-40, citing Tr., p. 210, lines 5-9 and Tr., p. 218, lines 11-16.) Furthermore, while criticizing Staff in its rebuttal and surrebuttal testimony, Aqua itself failed to propose any adjustment to incorporate increased rate case expense in its updated revenue requirements. Unlike its treatment of the increased lime expense that Aqua proposed in its rebuttal testimony and included in its rebuttal revenue requirement, Aqua continued to include its original rate case expense adjustment amount in the rebuttal and surrebuttal revenue requirements. (Tr., pp. 99-100; *See* Aqua Exhibit R-2.0, Schedule R-2.1 and Aqua Exhibit S-2.0, Schedule S-2.1.) Finally, late on November 12, 2004, essentially one business day before the start of the evidentiary hearing, Aqua provided Staff with limited information regarding its increased estimate. This timing precluded any discovery regarding the information, even though some of the information was from July, August, September and October 2004. (Staff IB, p. 42.) Nevertheless, as cross-examination of both Staff and Aqua witnesses demonstrated, the information provided was inadequate to support Aqua's increased estimate. (Staff IB, p. 40, citing Tr., p. 218, lines 5-9 and Tr., p. 218, lines 11-16.) Since the record does not contain adequate support for the increased rate case expense estimate and no

[1] Aqua also alleges that it has been forced to litigate issues such as the non-existence of an alleged double inclusion of Collection Fees. Staff disagrees with this characterization and the underlying premise of Aqua's contention as explained in more detail in Section II.A.4.

witness presented testimony that incorporated such an adjustment in Aqua's revenue requirement, the Commission should not now impute such an adjustment. The Commission should grant Aqua recovery of rate case expense as set forth in Aqua's direct testimony and to which Staff has proposed no adjustment.

B. Cost of Common Equity

Aqua asserts that it has fully supported a 10.75% cost of common equity cost rate. (Aqua IB, pp. 29-30.) To the contrary, Aqua's cost of common equity is based on the same forms of the discounted cash flow ("DCF") model, the Capital Asset Pricing Model ("CAPM"), the risk premium model ("RPM") and the comparable earnings model ("CEM") the Commission rejected in Docket No. 03-0403. (Staff IB, p. 48, citing 03-0403 Order, pp. 41-43.) Further, Aqua offered no new arguments that explain why the Commission should reverse its longstanding rejection of the Aqua cost of equity methodologies.

Aqua claims that Staff's analysis is inconsistent with the Commission Order in Aqua's most recent rate proceeding, Docket No. 03-0403, in that (1) Staff did not add an investment risk premium to its cost of common equity recommendation in recognition of Aqua's NAIC-2 designation and (2) Staff did not adjust its analysis to reflect the current interest rate environments vis-à-vis the interest rate environment that existed during April 2004 when the Commission issued the Docket No. 03-0403 Order. (Aqua IB, p. 30.)

Although the Commission allowed Aqua a 30 basis points adjustment to Staff's cost of equity recommendation in Docket No. 03-0403 (*Consumers Illinois Water Company, Tariffs seeking general increase in water rates for the Kankakee Water Division*

(Tariffs filed on May 21, 2003), Ill. C.C. Docket No. 03-0403, Order, p. 43 (April 13, 2004) (hereafter, "03-0403 Order")), the facts presented in this case do not justify an investment risk premium for Aqua. (Staff IB, pp. 61-62.) Unlike Docket No. 03-0403, Staff witness Rochelle Phipps performed a quantitative risk analysis of Aqua and concluded that adding an investment risk premium to Aqua's cost of equity is unwarranted. (Staff IB, p. 60.)

Staff's Initial Brief describes several reasons that Aqua's NAIC-2 designation does not automatically warrant adding an investment risk premium to its cost of equity. (Staff IB, pp. 58-62.) In summary, the NAIC-2 designation is not a credit rating because it does not relate to Aqua's investment risk and it is not intended for use by investors. Rather, that designation is assigned to certain of Aqua's debt issues and is produced solely for the benefit of NAIC members. (Staff IB, p. 58.) Moreover, Aqua's NAIC-2 designated debt securities might include terms that merit a lower NAIC designation than the general level of investment risk for Aqua because the NAIC considers security-specific factors when assigning its designations to certain debt issues. (Staff IB, p. 60.) Second, Ms. Ahern's assertion that NAIC-2 designations are equivalent to Standard & Poor's ("S&P") BBB and Moody's Investors Service ("Moody's") Baa credit ratings is unfounded. That is, Ms. Ahern failed to provide any documentation from Nationally Recognized Statistical Rating Organizations ("NRSRO"), such as S&P and Moody's that confirms the NAIC designations are equivalent to NRSRO-issued credit ratings. (Staff IB, p. 59.) Staff agrees that NRSRO-issued credit ratings are often a starting point for an NAIC debt analysis. Nonetheless, NRSRO-issued credit ratings are not necessarily the ending point of an NAIC debt analysis as the NAIC explicitly reserves the right to assign lower (but not higher) designations than the NRSRO-issued credit ratings would otherwise indicate. (Staff IB, p. 59, citing Aqua Schedule R-3.9, p. 5.) Finally, Ms. Ahern's speculative inferences regarding Aqua's NAIC designation are unnecessary given Ms. Phipps performed a quantitative risk analysis of Aqua, thereby rendering Ms. Ahern's reliance on the flawed "apples to oranges" comparison of NAIC designations and S&P and Moody's credit ratings unnecessary. (Staff IB, p. 60.)

Aqua incorrectly asserts that Staff refused to conduct an analysis that incorporates Aqua's NAIC-2 designation. (Aqua IB, p. 34.) To the contrary, Ms. Phipps performed a quantitative analysis of Aqua's risk in comparison to her sample companies and concluded Aqua is closer in risk to the water sample than the utility sample. Accordingly, Ms. Phipps assigned her water sample estimates twice the weight she assigned her utility sample estimates to derive her 10.07% cost of equity recommendation for Aqua. (Staff IB, pp. 53-54.) Ms. Phipps did not add an investment risk premium to her cost of equity recommendation because her analysis demonstrated that Aqua and the water sample are equivalent in risk and investors require the same rate of return from investments with equal risk. Adding an investment risk premium to Aqua's cost of equity would only be warranted if Aqua were riskier than <u>both</u> of Ms. Phipps' samples, which it is not. (*Id*.) Clearly, Aqua's assertion that Staff refused to conduct an analysis of Aqua's risk that incorporates Aqua's NAIC-2 designation is untrue.

During April 2004, the Commission entered its 03-0403 Order and authorized a 10.16% common equity cost rate for Aqua, which was derived by adding 30 basis points to Staff's 9.86% cost of equity recommendation. The Commission Order states that

Aqua proposed the 30 basis point adjustment to Staff's cost of equity recommendation. (Docket No. 03-0403 Order, p. 43.) Aqua wrongly claims that Ms. Phipps' 10.07% cost of equity recommendation is biased downward in comparison to both the 10.16% cost of common equity the Commission authorized in Docket No. 03-0403 and 10.49%, which Aqua alleges reflects the Commission authorized rate of return on common equity for Aqua, as adjusted to reflect current interest rates. (Aqua IB, p. 35.) Ms. Ahern asserts that in the current case, an adjustment is necessary to reflect the Commission finding within the context of today's "increased interest rate environment." Thus, Ms. Ahern recommended raising Staff's 10.07% cost of equity recommendation by up to 0.33% (Aqua IB, p. 35), which equals the difference between the 6.12% Baa-rated bond yield in March 2004 and the 6.45% Baa-rated bond yield in August 2004. (Aqua IB, p. 34.)

Aqua's argument contains several defects. First, if Ms. Ahern had reviewed the yield on Baa-rated utility bonds for April 2004, when the Commission entered the 03-0403 Order, rather than March 2003, the month before the Order was entered, she would have found that Baa-rated utility bonds yielded 6.46%. (Staff Cross Exhibit 3.) If Ms. Ahern had compared the April 2004 Baa-rated bond yield (i.e., 6.46%) to the August 2004 Baa-rated bond yield (i.e., 6.45%), then her logic suggests an adjustment to Ms. Phipps' 10.07% cost of equity recommendation would be unnecessary since the yields for Baa-rated utility bonds were the same during April 2004 and August 2004. (Staff Cross Exhibit 5.)

Second, the Commission's Order in Docket No. 03-0403 makes no mention of interest rates in either March or April 2004. Further, while the Commission did not explain how it arrived at a thirty basis point adjustment to Staff's cost of equity recommendation in that proceeding, it appears that thirty basis point adjustment is most closely related to the difference in the yield on A and Baa-rated utility debt. (03-0403 Order, p. 30.) While the yield spread between A and Baa-rated utility debt was 36 basis points in October 2003 (03-0403 Order, p. 30) and 31 basis points in September 2003, that yield spread had fallen to 15 basis points in March 2004 and 11 basis points in April 2004. (Staff Cross Exhibit 5.) Finally, the record in Docket 03-0403 was marked "Heard and Taken" on December 16, 2003. (03-0403 Order, p. 2.) Thus, the Commission's decision could not have been based on the precise interest rate levels prevailing at the time it entered its Order on April 13, 2004. March and April 2004 interest rates could not have been not part of the record that closed in December of 2003 and the Commission business risk adjustment was not commensurate with the March and April 2004 spreads between A and Baa-rated utility bond yields.

In contrast, it is clear that the Commission accepted Ms. Kight's September 2003 estimate of Aqua's cost of common equity, after adding 30 basis points for additional "business risk:"

> The Commission accepts Staff's methodology and base required rate of return on common equity of 9.86%. Although the Commission finds that several models supporting the Company's recommended cost rate should not be accepted, it does adopt the business risk premium as applied to CIWC under the facts of this case. Accordingly, the Commission concludes that the required rate of return on common equity for CIWC's water operations is 10.16%. (03-0403 Order, p. 43.)

Thus, any starting point for a comparison between the costs of common equity approved in Docket No. 03-0403 and recommended in this case should begin with September 2003, when Staff witness Sheena Kight presented her cost of equity analysis and recommended a 9.86% return on common equity for Aqua. In September 2003, Baa-rated utility bonds yielded 6.87%. (Staff Cross Exhibit 5.) Between

September 2003 and August 2004, when Ms. Phipps conducted her cost of common equity analysis, the yield on Baa-rated utility bonds had fallen 42 basis points to 6.45%. Thus, on interest rate movements alone, Ms. Phipps' cost of common equity estimate for Aqua should have been 42 basis points lower than Ms. Kight's, or 9.44% (i.e., 9.86% – 0.42% = 9.44%), rather than 21 basis points higher (i.e., 10.07% – 9.86% = 0.21%). Clearly, Ms. Phipps' recommendation represents a significant increase to Aqua's cost of common equity above what interest rate movements would explain in isolation.

Third, if one were to suspend disbelief and compare differences between cost of common equity recommendations and the authorized rate of return on common equity in Docket No. 03-0403 using changes in interest rates since March 2004 as a benchmark, then one must conclude that Aqua's proposed 10.75% rate of return on common equity is inconsistent with the Commission's cost of equity determination in Docket No. 03-0403. By Aqua's own argument, its 10.75% rate of return on common equity is too high given Aqua's assertion that a 10.49% rate of return on common equity is merited due to "today's significantly higher interest rate environment." [2] (Aqua IB, pp. 35-36.)

The table below summarizes historical spreads between A- and Baa-rated utility bonds.

[2] Moreover, in comparison the August 2004 A-rated bond yields that Aqua cites (i.e., 6.14%), Aqua's 10.75% proposed rate of return on common equity would result in a 4.61% equity risk premium for Aqua, which exceed the equity risk premiums that Ms. Ahern suggests are appropriate for A-rated public utility bonds (i.e., 3.5%/3.7% and 3.9%). (Aqua IB, pp. 33-34.)

Historical Spreads for Long-Term Utility Bonds			
Date	Baa-Rated Bonds	A-Rated Bonds	Spread as presented in basis points ("BPS")
September 2003	6.87%	6.56%	31 BPS
March 2004	6.12%	5.97%	15 BPS
April 2004	6.46%	6.35%	11 BPS
August 2004	6.45%	6.14%	31 BPS
Source: Staff Cross Exhibit 5			

Finally and most importantly, Ms. Phipps testified that Aqua's proposed cost of equity adjustment should be rejected because it is based on the incorrect assumption that cost of equity estimates are solely a function of interest rates. In contrast, cost of equity estimates are not only a function of interest rates, but also a function of the price of risk at a given point in time. (ICC Staff Exhibit 7.0, lines 219-228.)

Aqua asserts further that interest rates are expected to continue to rise. (Aqua IB, pp. 34-35.) The table below compares projected yields for Aaa-rated public utility bonds, as published in the October 1, 2003, issue of *Blue Chip Financial Forecasts* ("*BCFF*") (Staff Cross Exhibit 3) and the actual yields for Aaa-rated public utility bonds, as published in *Mergent Bond Record* ("*Mergent*"), during September 2004 and *BCFF* on October 1, 2004 (Staff Cross Exhibit 5):

Aaa-Rated Public Utility Bond Yields		
Measurement Period	**Projected**	**Actual**
4th Quarter 2003	5.9%	5.7%
1st Quarter 2004	6.0%	5.5%
2nd Quarter 2004	6.1%	5.9%
3rd Quarter 2004	6.3%	5.7%
The October 1, 2004, *BCFF* is the source for the actual 3rd Quarter 2004 yield only.		

As this table demonstrates, and as Ms. Phipps testified, interest rate forecasts are very inaccurate. (Staff IB, p. 46, citing ICC Staff Exhibit 3.0, lines 1115-1120.) Thus, Aqua's interest rate projections should not be given any weight in this proceeding and the Commission should adopt Staff's 10.07% cost of equity recommendation for Aqua.

Aqua asserts that Staff's analysis contains the following flaws: an exclusive reliance on the DCF model, reliance on spot stock prices, incorrect betas, inadequate sample selection criterion and a failure to account for Aqua's size in comparison to the size of the companies comprising her proxy groups. (Aqua IB, p. 30.) Each of those alleged flaws in Ms. Phipps' analysis was addressed at length in Staff's Initial Brief. Staff's position on each of those issues is summarized below.

Aqua asserts that the DCF-derived total market return ("R_M") that Ms. Phipps' used in her CAPM analysis is grossly understated because the market-to-book ratio of the S&P 500 was 289%, which is significantly greater than unity. (Aqua IB, p. 31.) Staff's Initial Brief describes why market values and book values might differ and cites several prior rate cases in which the Commission rejected similar market-to-book value arguments, including Aqua's last rate case, Docket No. 03-0403. (See Staff IB, pp. 76-78, citing Order, Docket Nos. 02-0798/03-0008/03-0009 Cons., p. 87 (October 22, 2003); Order, Docket Nos. 92-0448/03-0239, p. 89 (October 11, 1994); Order, Docket No. 97-0351, p. 24 (June 3, 1998); and Order, Docket No. 03-0403, p. 42 (April 13, 2004).) Importantly, in the *Federal Power Commission et al. v. Hope Natural Gas Co.* ("Hope") decision, to which Ms. Ahern refers frequently (Aqua Exhibits S-3.0, lines 294-310; R-3.0, lines 1078-1094; 3.0, p. 6), the court stated:

> Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base.

(*FPC v. Hope Natural Gas Co.*, 320 U. S. 591, 605, 64 S. Ct. 281, 289 (1944).) Thus, the Hope decision confirms that the allowed rate of return on book value need not be increased even if the resulting rate of return on market value is ”meager”. That is, an authorized return on equity for a public utility need not be adjusted to target a minimum return on market value, rendering the market-to-book value ratio irrelevant.

The groundless nature of Aqua’s claim that Ms. Phipps’ estimate of R_M for her CAPM is grossly understated due to a DCF bias is clear given that Ms. Phipps’ 13.54% estimate of R_M is higher than the 12.2% estimate of R_M Ms. Ahern calculated from historic non-DCF data. Thus, Ms. Ahern’s claim of a downward DCF bias is unfounded. (Staff IB, pp. 77-78, citing ICC Staff Exhibit 7.0, lines 331-337.) Moreover, Staff asserts that R_M, which is a forward-looking measurement, can only be estimated through a DCF calculation without resorting to untimely, obsolete, historical data. Staff asserts further that Ms. Ahern’s criticism is disingenuous since in addition to using an historical R_M, Ms. Ahern’s Risk Premium and Capital Asset Pricing models also estimate R_M with the DCF model. That is, both Value Line and DCF-based estimates of R_M equal a dividend yield, plus a growth rate. (Staff IB, pp. 75-76, citing ICC Staff Exhibit 7.0, lines 274-277.)

Aqua asserts that Staff’s use of spot stock prices “does not accurately reflect the cost rate of common equity of the operating, regulated water utility on an ongoing, continuing basis.” (Aqua IB, p. 31.) Although Ms. Ahern acknowledged that DCF theory indicates spot prices should be used in DCF analysis, she alleged that average historical stock prices are necessary to normalize the effect of market aberrations, volatility and dramatic company-specific events upon stock prices. (Aqua Exhibit R-3.0, p. 9.) Ms. Ahern also claimed that most regulatory agencies do not rely upon spot stock prices in applying the DCF model. (Aqua Exhibit S-3.0, lines 225-226.) Ms. Phipps explained that the only shortcoming of spot prices Ms. Ahern cites (*i.e.*, volatility) can be mitigated through the use of samples, a technique both Staff and Aqua implement. (ICC Staff Exhibit 7.0, lines 643-652.) Thus, historical data are not only inappropriate, but also unnecessary. (*Id.*) Further, Ms. Ahern provided no support for her claim that most regulatory agencies do not rely upon spot stock prices in applying the DCF model. (Staff Cross Exhibit 7.)

Staff asserts further that Ms. Ahern's arguments regarding the superiority of historical average dividend yields for DCF analysis is superfluous and should not be given any weight in this proceeding because the spot dividend yields and historical dividend average dividend yields that Ms. Ahern applies for each of her samples are nearly identical. Specifically, Ms. Ahern's water sample's spot dividend yield is 3.1% and the three-month average dividend yield is 3.0%. (Aqua Exhibit 3, Schedule 10.) Likewise, her utility sample's spot and three-month average dividend yields are both 4.0%. (*Id.*) In addition to the reasons historical average dividend yields are improper inputs for DCF analysis as set forth in Staff's Initial Brief on pages 62-64, Ms. Ahern's arguments regarding the volatility in spot stock prices should not be given any weight in this proceeding because Ms. Ahern's DCF analysis would have produced identical results whether she relied solely upon spot stock prices or historical average dividend yields.

Aqua falsely asserts that Staff's regression beta estimates cause disparities from the investor-required rate of return because the regression beta estimates (1) are not utilized by the investment community; and (2) substitute the S&P 500 for the NYSE

Composite Index as a proxy for the market. (Aqua IB, p. 32.) Staff defends its use of regression beta estimates in its Initial Brief on pages 78-79 and the Commission has approved Staff's regression beta estimates in past rate cases, including Docket No. 03-0403 (e.g., Order, Docket No. 02-0837, pp. 37-38 (October 17, 2003); Order, Docket Nos. 02-0798/03-0008/03-0009 Cons., p. 85 (October 22, 2003); Order, Docket No. 00-0340, p. 25 (February 15, 2001) and Order, Docket No. 03-0403, p. 42 (April 13, 2004).) Foremost, nothing in financial theory posits it is inappropriate for an investor to calculate her own betas. (ICC Staff Exhibit 7.0, lines 343-345.) Nonetheless, Ms. Phipps reproduced Merrill Lynch's beta estimation methodology and confirmed the accuracy of those beta estimates by comparing them to Yahoo's published beta estimates, which are calculated using the same methodology as Merrill Lynch. The Merrill Lynch beta estimation methodology produced adjusted beta estimates of 0.36 and 0.42 for Ms. Phipps' water and utility samples, respectively, which are lower than the regression beta estimates Ms. Phipps derived for her CAPM analysis. Hence, if Ms. Phipps were to include Merrill Lynch beta estimates in her CAPM analysis, then her CAPM-derived cost of equity estimates would be lower rather than higher. (Staff IB, pp. 78-79.) Thus, Aqua's disagreement with Staff's regression beta estimates appears to be another argument for the sake of argument, and should not be given any weight in this proceeding.

Ms. Ahern criticized Ms. Phipps' selection of the utility sample because of her use of S&P credit ratings and business profiles instead of computing "several operating and financial ratios" as Staff did in a prior Aqua case, Docket Nos. 00-0337/0338/0339 Cons. (Aqua Exhibit R-3.0, lines 212-226.) In response to Ms. Ahern's criticism, Ms.

Phipps performed a quantitative risk analysis of Aqua that used various operating and financial ratios. (ICC Staff Exhibit 7.0, lines 127-134.) Despite Aqua's vague, unexplained assertion that Staff's sample selection criterion is inadequate (Aqua IB, p. 30), Ms. Ahern did not criticize the presence of a single company in Ms. Phipps' samples. Ms. Ahern presented no evidence that Ms. Phipps' samples are not similar in risk to Aqua. In this case, Ms. Phipps employed the same sample selection methodology the Commission accepted in Docket Nos. 02-0690, 02-0837 and, importantly, 03-0403. (02-0690 Order, pp. 78-79 (August 12, 2003); 02-0837 Order, pp. 32 and 37 (October 17, 2003); and 03-0403 Order, pp. 29-30 (April 13, 2004).)

Aqua asserts that Ms. Phipps' cost of equity recommendation is understated because Ms. Phipps failed to apply a risk premium of 35 basis points to her cost of equity to account for Aqua's increased risks due to its size in comparison to the size of the companies comprising Ms. Phipps' water and utility samples. (Aqua IB, p. 32.) To the contrary, Staff's Initial Brief describes the reasons that Aqua's size does <u>not</u> merit a risk premium. (Staff IB, pp. 56-58.) Ms. Phipps testified that Ms. Ahern's size-based risk premium lacks a theoretical basis and the only published study of the relationship of utility size to risk did not find one. (Staff IB, p. 56.)

Ms. Phipps argued that, should a size-based risk premium be adopted, and it should not, it should be based on the size of Aqua's parent company, Aqua America, Inc. because Aqua obtains equity financing from its parent company. Basing a risk premium on the size of Aqua rather than its parent company would deny ratepayers a portion of the benefits associated with the combined entity's stronger financial profile. (Staff IB, p. 57.) Ms. Ahern asserted that a size premium is necessary because the size of Aqua's parent company is irrelevant given Aqua is the regulated utility whose rate base the overall cost of capital will be applied (Aqua IB, p. 32.) To the contrary, in support of Aqua's request to merge with its parent company, Aqua witnesses testified that the merger would enhance Aqua's ability to access the capital markets because of the combined entity's stronger financial profile. (Staff IB, p. 57, citing Order, Docket No. 97-0602, p. 3 (January 21, 1999).) Moreover, S&P states, the A+ credit rating for Aqua's affiliate, Aqua Pennsylvania, Inc. reflects the consolidated credit quality of the parent, Aqua America, Inc. (Staff Cross Exhibit 4.) Thus, Aqua's cost of equity should not be adjusted because it is a smaller company than the companies comprising Ms. Phipps' samples. Aqua's parent company, which provides Aqua with equity capital, is a financially strong entity that has access to the capital markets on reasonable terms. The benefits associated with Aqua's financially strong parent company should be passed through to ratepayers; thus, a size-based risk premium for Aqua is unwarranted.

Finally, even if one were to ignore Aqua's true source of equity financing and accept that size should be included as a risk factor, Ms. Phipps' quantitative analysis of Aqua's risk already reflects the effect of size through her inclusion of revenue and earnings stability (i.e., volatility) risk measures. (ICC Staff Exhibit 7.0, lines 143-147.) As Aqua Exhibit R-3.0, Schedule R-3.4, page 10, shows, the standard deviation of historical returns (*i.e.*, a measure of volatility) increases as company size decreases, which indicates earnings volatility is strongly correlated with company size. Therefore, Ms. Phipps' quantitative analysis incorporated the effect of Aqua's size on its risk.

Finally, Aqua incorrectly suggests that Ms. Phipps' 10.07% cost of equity recommendation in comparison to the 7.48% cost of debt recommendation she presented in her direct testimony results in a 2.59% risk premium for Aqua. (Aqua IB, p. 32.)[3] Aqua's comparison is invalid because it is based on Aqua's embedded cost of debt, which reflects interest rates that Aqua locked in as early as 1988, rather than current debt costs. (Staff IB, p. 80.) In fact, Ms. Phipps' cost of equity recommendation in comparison to the concurrent 5.81% A-rated bond yield produces a 4.26% risk premium (Staff IB, p. 79), which exceeds Ms. Ahern's estimate of an appropriate risk premium for A-rated public utility bonds (i.e., 3.5%-3.9%). (Aqua IB, pp. 32-33.) Significantly, Ms. Ahern's own cost of common equity analysis, while replete with risk premium analyses that are variously based on U.S. Treasury bond yields, high-grade corporate bond yields, and A-rated utility bond yields, include none that use the embedded cost of debt as a starting point for determining the cost of common equity. If Aqua's embedded cost of debt had any valid role in determining its cost of common equity, and it does not, then consistency dictates that Ms. Ahern should have used the embedded cost of debt in her own analysis of Aqua's cost of common equity. She did not. Thus, Staff's 10.07% cost of equity recommendation is reasonable and should be adopted by the Commission.

C. Cost Of Service And Rate Design

1. Fourth Usage Block

The Company has decided not to contest Staff's elimination of the fourth usage block from the Vermilion rate structure. (Aqua IB, p. 36.) Staff's Initial Brief explains why the fourth usage block should be eliminated. (Staff IB, pp. 82-84.) Accordingly, the

[3] Note that Ms. Phipps revised her estimate of Aqua's embedded cost of long-term debt to 7.18% in her rebuttal testimony. (Staff Ex. 7.0, Sch. 7.2)

Commission's order in this docket should require the elimination of the fourth usage block from the Aqua Vermilion tariffs.

2. Increase in Customer Charges

Staff's Initial Brief explains why customer charges should not be increased. (Staff IB, pp. 84-87.) Despite Staff's cost of service study ("COSS"), which showed that customer charges should not be increased because revenues from current customer charges exceed test year customer costs, Aqua stated that customer charges should generally be increased (Aqua Initial Brief, pages 36 through 38). Since revenues from current customer charges exceed test year customer costs, customer charges should not be increased.

The only exception to Staff's general proposal to keep customer charges at their current levels is the customer charge for the 6-inch turbine meter applicable to the Large Industrial customer class. It is appropriate to treat this customer class differently because, unlike the other customer classes, Staff's proposed rates do not recover the overall Large Industrial customer class revenue requirement. (Staff IB, pp. 84-85.) If the Large Industrial customer class 6-inch turbine meter customer charge is not increased, it will be necessary to increase the Large Industrial usage charge above the Staff-proposed usage rate in order to recover 60 percent of the Large Industrial class cost of service at Staff's revenue requirement. (Id.)

Staff's Initial Brief addressed most of the arguments that the Company put forth for an increase in customer charges in its Initial Brief, including the effect of the currently applicable QIPS and the possibility that certain low-use customers may temporarily experience a rate decrease until the QIPS rises to its current maximum of five percent. (Staff IB, p. 86.) To summarize, the indirect effect of the currently-applicable QIPS should not affect this docket's evaluation of customer charges because the QIPS was not designed to be a substitute for a COSS, as acknowledged by the Company. (Tr., p. 181, lines 10-14.) The QIPS is an interim, broad-based percentage increase applied between rate cases for new qualifying infrastructure to all charges on a customer's bill, and does not provide a basis to permanently increase each charge because the interim percentage increase is not based upon a timely COSS.

Staff's customer charges are based upon the Staff COSS. A COSS takes into consideration the costs the utility has in the test year, functionalizes those costs according to type of cost, and classifies the functionalized costs according to customer class. To the extent possible, rates are then designed to reflect the results of the COSS so that each customer class cost of service is recovered according to the type of costs included in each customer class cost of service.

The Company presents a novel approach to developing customer charges by proposing in its brief to tie the amount of its proposed increase in customer charges to overall test year revenues to be paid by the Large Industrial customer class. (Aqua IB, pp. 37-38.) The Company terms this a "compromise" proposal, but it is not at all linked to the COSS in this docket. Other than to describe as a compromise its proposal to link the increase in customer charges paid by customers other than Teepak to the overall revenues paid by the Large Industrial customer class, which would include both the customer charge revenues and usage charge revenues from the Large Industrial customer Teepak, the Company did not explain why customer charges should be linked to overall revenues paid by one single customer class.

The Company's failure to explain the basis for linking the customer charge paid by customers other than the Large Industrial customer class to overall revenues paid by the Large Industrial customer class is understandable because there is no reasonable basis for such a link. Since there is no cost of service basis for the Company's "compromise" approach in developing customer charges, the Company's proposed customer charge that starts at either $13.33 per month or $13.13 per month for a 5/8th-inch meter should be rejected. Since current customer charges more than adequately recover the test year customer costs that the customer charge is designed to recover (Staff IB, p. 85; ICC Staff Exhibit 4.0, p. 19, Appendix A, lines 49- 59), the Commission should accept Staff's recommendation to leave customer charges at their current levels, and reject the Company's novel, alternative approach that would over-weight revenue recovery from the customer charge, and reject as well the Company's position regarding how the current QIPS should affect customer charges resulting from this docket.

3. Teepak (Large Industrial Customer Class)

Staff's Initial Brief explains why it is necessary to increase Vermilion Large Industrial Customer Class rates above the Company's proposed minimal increase in those rates, and further explains why Staff's proposed Teepak rates represent a reasonable balance between cost recovery from a major consumer of water in the Vermilion service area and an incentive, discount rate to retain that customer as an Aqua customer. (Staff IB, pp. 87-90.)

The Company's proposed Teepak rates would continue to move revenues further away from Teepak cost of service, from 48.7 percent of test year cost of service in the previous Vermilion rate increase, Docket Nos. 00-0337, -0338, and –0339 (consol.)

(ICC Staff Exhibit 8.0, p. 14, lines 281- 285), down to only 45.4 percent of cost of service at Staff's rebuttal revenue requirement (ICC Staff Exhibit 8.1, p. 2, TOTAL REVENUES - Proposed divided by PER STAFF – Cost of Service, $483,954/$1,065,639 = .4541). If the Commission finds that the Vermilion revenue requirement should be higher than Staff's recommendation, then the Company's proposed Teepak rates would recover a smaller percentage of cost of service because the Company's proposed Teepak rates in this docket are fixed and are not tied to the particular revenue requirement ultimately approved.

If Teepak's rates continue to recover smaller and smaller percentages of its cost of service, the subsidy from other customers to encourage Teepak to remain as an Aqua customer will continue to grow. For example, ICC Staff Exhibit 4.2 shows that, in this docket, Commercial customers would pay 3.7 percent less if Teepak paid its full cost of service compared to Staff's proposed rates where Teepak would pay only 60 percent of its cost of service (ICC Staff Exhibit 4.2, p. 2, TOTAL REVENUES - Staff divided by ICC Staff Exhibit 4.1, p. 2, TOTAL REVENUES - Staff, $2,103,617/$2,027,839 = 1.0374). The Company's proposed rates would require a greater subsidy from other Aqua customers because the Company's proposed rates recover at least $155,048 less from Teepak, depending upon revenue requirement (ICC Staff Exhibit 4.1, p. 2, TOTAL REVENUES – Staff minus TOTAL REVENUES – Proposed, $631,920 - $483,954 = $155,048). The difference in Teepak revenues would be recovered from other customers in order for Aqua to recover its Vermilion test year revenue requirement.

Staff does not dispute that it is reasonable for the Company to confer with Teepak -- a major customer – about how it views and might react to a rate increase. (*See* Aqua IB, p. 40.) It is not surprising that Teepak would prefer a minimal increase in rates. Most utility customers would prefer to pay little or nothing for the treated water they consume, but unfortunately, the process to treat and distribute water creates real costs. (Tr., p. 297, lines 7 through 18). Although it is reasonable to consider how Teepak may react to a rate increase, there can be no question that it would be improper to not take into account what is reasonable and fair to all customers in designing rates. Staff's proposed Teepak rates are a reasonable balance between the benefits to other Vermilion customers from retaining Teepak as a Vermilion customer with the costs to other Vermilion customers of funding a substantial discount to Teepak.

Staff finds it difficult to understand how Teepak, which is not a professional water treatment and distribution company, can construct, operate, and maintain a new water treatment facility at a cost far less than 60 percent of the cost to Aqua, which is a professional water treatment and distribution company. (Staff IB, pp. 89-90). Moreover, Staff's proposed Teepak rates are less than 1/3rd of the average cost per CCF of water provided by Aqua to the Vermilion system as a whole. With these apparent advantages to Aqua under Staff-proposed rates for retaining Teepak as a customer, it would seem that either Teepak is overly optimistic in its estimate of the costs to build, operate, and maintain a water treatment facility or that Aqua is significantly overpriced. The Company's discussion of the steps Teepak has taken with respect to constructing its own water treatment facility, such as repeat consultations with specialists who have designed and developed cost models for a Teepak stand-alone well water treatment plant, verge on being stale since the plans for the water treatment facility have not been updated for four years. (Tr. p. 152, line 21 through p. 153, line 13.) Finally, Teepak has not received any formal bids to construct its water treatment facility. (Id.) With four-plus year old plans, and no formal construction bids, it is reasonable to view the Teepak estimates as rough estimates and subject to increase.

The Company suggests that Staff "plays a game of chance" or "calls Teepak's cards" with respect to Teepak rates. (Aqua IB, p. 40.) Staff's proposed Teepak usage rate is nearly 65 cents per CCF less than Staff's proposed general third usage block, which is the next lowest usage rate available to Vermilion customers, and is only 63 percent of the third usage block rate. Staff-proposed rates are discounted to 60 percent of the Aqua cost of service to Teepak, are less than 1/3rd of the overall Vermilion system average cost per CCF of water, are 65 cents per CCF less than the next lowest generally available usage rate, and are only 63 percent of the next lowest generally available usage rate. The significant discounts proposed by Staff for Teepak show that Staff's proposal involves considerable thought and is a far cry from Aqua's unreasonable and unwarranted spin that Staff is merely "playing a game of chance" or "calling Teepak's cards". The best and proper approach balances the interest of retaining Teepak on the system with the goal of designing fair and reasonable rates that bear a rational relation to Teepak's cost of service, as represented through Staff's proposed rates.

For all the reasons stated above, the Commission should approve Staff's rate design and reject the Company's increased discount over already steeply discounted Teepak rates. Staff's proposal continues to provide a very significant discount to

Teepak, while making a modest increase in Teepak's percentage contribution (from 48.7% to 60.0%) to recovery of its cost of service.[4] Staff's proposed Teepak rates are a reasonable balance between cost recovery from a major consumer of water in the Vermilion service area and an incentive, discount rate to retain that customer. The Commission should approve Staff's rate design for Vermilion, including rates applicable to Teepak.

[4] Nonetheless, if the Commission declines to accept Staff's proposal, the Commission should, at a minimum, require Teepak to continue to pay the same 48.7 percent of cost of service from the last Vermilion rate increase, Docket Nos. 00-0337, -0338, and –0339 (consol.). Teepak's rates under this approach would increase by approximately 13.7 percent for a total of $518,966 in total annual Teepak revenues at Staff's rebuttal revenue requirement. Other customers would have to pay more to make up the $120,036 reduction in revenues from Teepak in order for Aqua to recover the Staff revenue requirement.

III. CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding.

Respectfully submitted,

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